

DEALING WITH INCREASING DEFICITS AND DEBT TO AVOID A FISCAL CRISIS

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ABSTRACT

The budget and the economic outlook for 2020–2030 reported by the Congressional Budget Office sheds light on the prospects of a fiscal deficit and debt that are already high and still increasing and which could pose significant risks for the nation in terms of financial vulnerability and the ability to respond to future crises. As we can see from the most recent historical facts, the near-term drivers of deficits and debt are making the long-term fiscal scenario unsustainable. For that reason, this paper proposes an increase of the corporate tax rate from 21% to 25, focusing on those short-term events with the objective to stabilize deficits and debt over the next ten years. After evaluating the set of positive and negative elements of the proposal, the conclusion is that a higher corporate tax rate would lower the fiscal deficit by \$500 billion over 10 years, which is equivalent to one percentage point of the debt-to-GDP ratio. The initiative would also allow policymakers to manage deficits below the \$1 trillion mark over the same period. Finally, the initiative proposed would cut the debt ratio by 5% of GDP by 2050. These positive elements should be adjusted by the economic costs faced by corporation, amid a higher tax rate. However, given the current situation regarding the Covid-19 pandemic, it would not be appropriate to increase taxes this year this year. In the best-case scenario, such an initiative should wait until 2021 or until the economy recovers from the recessive stage of the business cycle, to be proposed and discussed in Congress.

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To my parents: an example of humbleness and love.

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Action-Forcing Event:

On January 28th, the Congressional Budget Office (CBO) released a report on the 2020 budget and the economic outlook for 2020–2030 stating that fiscal deficit will reach the \$1.02 trillion mark this year,¹ a negative balance that would be “higher than any other record outside of the Great Recession and its aftermath.”² Given that Congress granted the executive branch greater influence in domestic affairs after the 9/11 terrorist attack and the 2008 financial crisis and the Great Recession that followed, the time has come for lawmakers to take action, bearing in mind that solving the problem of the U.S. deficit and debt will require special attention to not only to the effects of these events, current legislation, and increasing health and retirement costs, but also to the growth of executive power relative to that of Congress in budget matters.

If Congress does not take action, the country will face a greater risk of fiscal crisis and reduced fiscal space that will increase the difficulty of dealing with a new economic recession, wars, and other national emergencies, all the while undermining the separation of powers.

¹ Committee for a Responsible Federal Budget, “Analysis of CBO’s 2020 Budget and Economic Outlook,” January 28, 2020, <http://www.crfb.org/papers/analysis-cbos-budget-and-economic-outlook-january-2020>, accessed January 29, 2020.

² Congressional Budget Office (CBO), “The Budget and Economic Outlook: 2020–2030,” January 28, 2020. www.cbo.gov/publication/56020, accessed January 29, 2020.

Statement of the problem

The 2020 CBO report concerning the budget and the economic outlook for 2020–2030 sheds light on the prospects of a fiscal deficit and debt that are already high and still increasing and which could pose significant risks for the nation in terms of financial vulnerability and the ability to respond to future crises. One of the most worrisome conclusions of the report is that the 2020 estimates point to a \$1.02 trillion deficit, which is equivalent to 4.6% of GDP. Regarding the debt projection for the same year, the non-partisan agency estimates that federal debt held by the public could increase to 81% of GDP.³ In addition, the document highlights that, except for a six-year period during and after the Second World War, the deficit recorded over the past century never exceeded 4% of GDP for more than five consecutive years.⁴ Moreover, the CBO warns on the deviation of the deficit figure as compared to the average deficit of 1.5% of GDP reported during the past 50 years during those periods when the economic environment was as favorable as it is currently.

Regarding the long-term prospects, the CBO estimates that, under the current law scenario, the deficit figure could be around 5.4% of GDP, while the federal debt held by the public could increase to 98% of GDP in 2030, which would be a new record for the period since 1946 when calculating the debt as a proportion of GDP (Chart 1). Beyond 2030, the report concludes that, under a similar scenario, together with current laws, the federal debt held by the public could increase to 180% of GDP in 2050 (Chart 1), a figure that is “far higher than it has ever been.”⁵ Moreover, the Committee for a Responsible Fiscal Budget (CRFB) notes that, in the absence of an alternative fiscal scenario, the possibility of an extension of the recent legislation with tax cuts

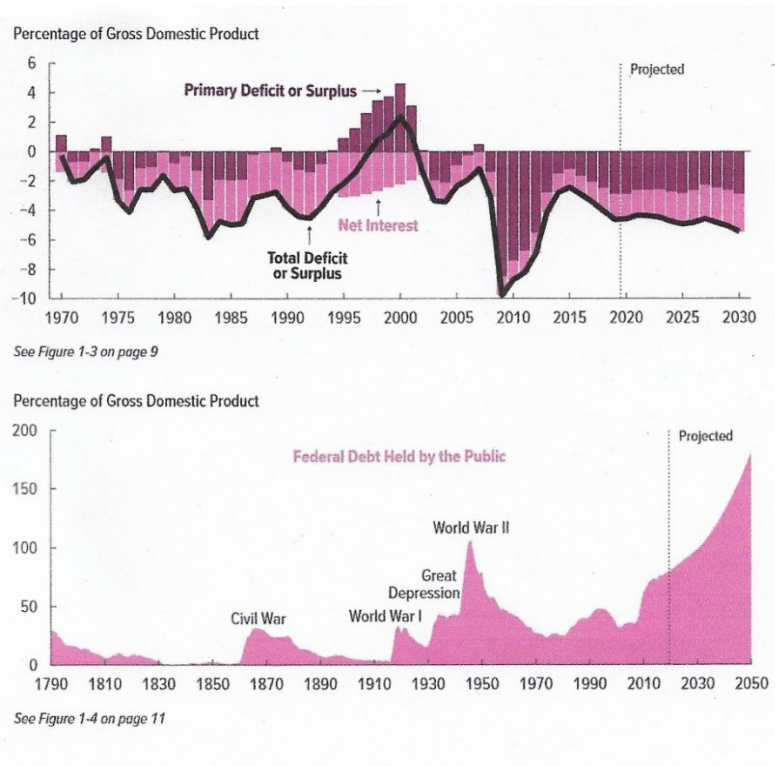
³ Congressional Budget Office, “The Budget and Economic Outlook: 2020–2030.”

⁴ Ibid.

⁵ Ibid, 2.

and higher discretionary spending (Tax Cuts and Jobs Act) would cause debt to increase to 107% of GDP in 2030, which would represent “an all-time record.”⁶ The CRFB also estimates that, under this scenario, budget deficit would total \$2.4 trillion or 7.4% of GDP by 2030.⁷

Chart 1: Deficits and Debt as a Percentage of GDP.⁸



Source: CBO.

Why is the problem of deficits and debt important?

The consequences of rising federal debt were also an important topic that was analyzed in the CBO report. For instance, if debt continues to increase at the projected pace and the current laws remain and increasing spending continues, the debt trajectory will affect economic activity and the interest costs related to the increased debt, resulting in a decline in the income of

⁶ Committee for a Responsible Federal Budget, “Analysis of CBO’s 2020 Budget and Economic Outlook.”

⁷ Ibid.

⁸ Congressional Budget Office, “The Budget and Economic Outlook: 2020–2030.”

American households over time. In addition, increasing debt over the years to come could reduce the fiscal space and, therefore, the ability of the government to respond to national emergency situations and economic recessions or to strengthen national defense.

The 2020 deficit and debt projections by the CBO in the absence of a recession or any sort of financial emergency increase concerns regarding the ability of the country to deal with an economic downturn in the future. For this reason, a first step toward a sustainable fiscal environment that will prevent the deterioration of the situation as described above is required. It is essential to identify what is driving increased deficits and debt by separating short- and long-term factors. In other words, the origins of the problem of the high deficit and debt depend on the time period that is being analyzed. Once this distinction between near- and long-terms drivers of deficits and debt is established, potential solutions could be applied to each case. In short, such a distinction would assist in answering the following question: If the country is not in a recession, what is driving the increasing deficit and debt?

1. Past Deficit and Debt were Largely a Result of the Great Recession

The start of this decade saw the emergence of deficits exceeding the \$1.0 trillion mark as a result of the Great Recession of 2008 and the measures enacted to combat it. Fiscal deficits recorded in both 2010 and 2011 were \$1.3 trillion, whereas that recorded in 2012 was \$1.1 trillion. Once the economy recovered from the recession, the gap between federal receipts and outlays declined, which contributed to reductions of the deficit in 2013 and 2015 amounting to \$680 billion and \$442 billion, respectively, due to the deficit reduction measures implemented during those years.⁹

⁹ Committee for a Responsible Federal Budget, "The Decade in the Federal Budget," December 30, 2019, <http://www.crfb.org/blogs/decade-federal-budget> accessed February 7, 2020.

2. Current Deficits and Debt Explained by Current Legislation

Since the Great Recession and measures to lower fiscal deficits ended, new deficit-increasing legislation has caused deficits to show continuous growth, recording \$665 billion in 2017 and \$984 billion in 2019. For instance, the Budget Control Act of 2011, which is the major tool for deficit reduction legislation enacted in the past decade, reduced and capped discretionary spending over a 10-year period. In addition, some budget agreements in 2013 and 2015 allowed for deficit and debt reduction. However, the 2017 Tax Bill and other budget agreements reached in 2018 repealed sequestration, with a consequent increase in spending but without a corresponding increase in federal receipts. Moreover, the tax bill caused a decline in terms of federal receipts, in line with an analysis from the Congressional Research Service (CRS) stating that 2019 revenues were estimated in 16.1% of GDP; a figure that is below the post-World War II average around 17% of GDP.¹⁰

Moreover, the 2020 \$1.0 trillion deficit projection and the 10-year prospects strongly relate to the appropriation package enacted in December last year, which includes a permanent repeal of taxes enacted to finance the Affordable Care Act.¹¹ According to the CBO, the package will add more than \$500 billion to the deficit figure through 2029.¹²

3. Long-term Deficits and Debt Related to Increasing Health Care Spending, Entitlements, and Higher Retirement and Interest Debt Costs

Apart from the effects of the 2017 TCJAC on deficits and debt, the CRFB estimates that health care spending retirement, and interest debt cost would represent 12% of GDP in 2020 and 15.6% of GDP 10 years into the future. In a more worrisome scenario, Social Security, Medicare and

¹⁰ Library of Congress, Congressional Research Service, "Overview of the Federal Tax System in 2019." Updated November 20, 2019. <https://fas.org/sgp/crs/misc/R45145.pdf>. Accessed February 28, 2020.

¹¹ Committee for a Responsible Federal Budget, "Analysis of CBO's 2020 Budget and Economic Outlook."

¹² Ibid.

Medicaid, and interest debt payments will absorb 82% of the \$2.8 trillion projection of the increase in nominal spending through 2030.¹³ Regarding entitlement programs different from Medicare and Medicaid, the Supplemental Nutrition Assistance Program (SNAP), the Pell Grant Program, the Supplemental Security Income (SSI), and the Temporary Assistance for Needy Families (TANF) represent about \$175.6 billion in annual costs.¹⁴

Why Focus on one of the Short-Term Drivers of Increased Deficits and Debt?

One of the effects of the 2017 TCJA is that, under the new code, the tax system is less progressive. For instance, a recent report released by the CRS concludes that corporate income tax revenues have become a smaller share of overall tax revenues over time, while social insurance revenues have trended upward as a share of total revenues. For example, the corporate income tax accounted for roughly 30% of federal revenue in 1946, but 9% in 2016. In 2019, corporate income tax revenues were about 6% of total revenues. In contrast, receipts for social insurance and retirement taxes have risen post-World War II with the enactment of Social Security and Medicare and are now the second-largest source of federal receipts at approximately 36% of federal revenue. Given the scenario above, the corporate income tax is estimated to generate another \$216 billion in revenue in FY2019, or just over 6% of total revenue. Social insurance or payroll taxes will generate an estimated \$1.2 trillion, or 36% of revenue in FY2020.

¹³ Ibid.

¹⁴ Federal Safety Net. <http://federalsafetynet.com/index.html>. Accessed March 5, 2020

History/Background

The years before the current problem with deficits and debt

The problem of increasing deficits and debt in the contemporary U.S. fiscal policy became relevant again after a period during which the debt stabilized under President Clinton's administration. In those years, efforts to control Federal deficits and debt in terms of GDP initiated a turning point regarding the way the economy was managed, especially during Ronald Reagan's administration. The debt problem recorded in the early 1990s was the result of larger deficits driven by the so-called supply-side-economic policies implemented by President Reagan. For instance, among different tax initiatives under the Tax Reform Act of 1986, the corporate income tax rate was cut from 46% to 40%, followed by a second reduction in 1988 at 34%.¹⁵ As a result of this kind of policies that affected revenues, the proportion of debt calculated as a share of the economy climbed from 25.2% in 1981 to approximately 39.8% in 1988.¹⁶ Given the imbalances recorded during those years, President Clinton's administration made significant efforts to deal with the increasing deficits and debt problem through a mix of policies consisting, amongst others, of raising tax rates for high-income individuals and cutting key expenses on welfare and defense. Regarding the tax reform policies included in the Omnibus Budget Reconciliation Act of 1993, the corporate tax rate increased from 34% to 35%, in combination with other initiatives such as the increase in the taxable portion of social security benefits and the adjustment of the individual tax

¹⁵ Tempalski, Jerry, "Revenue Effects of Major Tax Bills" U.S. Department of Treasury. September 2006. <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-81.pdf>

¹⁶ Congressional Budget Office. "Historical Tables." <https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51129-2016outlookonecol-2.pdf> (Retrieved July 2, 2019).

rate from 36% to 39.6%.¹⁷ As a consequence, the country exhibited a four year-period with fiscal surplus,¹⁸ while the debt-to-GDP ratio dropped from 44% in 1993 to 31.4% in 2001.¹⁹

Terrorist attacks 9/11, the Financial Crisis, and the Great Recession

However, the terrorist attacks of 9/11 at the start of George W. Bush's first term as President, combined with a new period of tax cuts, caused debt measured in terms of GDP to rebound again to 39.3% in 2008. According to the 2016 CBO report, the increase of debt as a share of the size of the economy was due to a period of significant tax cuts and an increase in defense spending concerning the aftermath of the 9/11 terrorist attacks.²⁰ While no corporate tax cut rate was enacted in the two President Bush's administration, the set of tax cuts included in the Economic Growth and Tax Reconciliation Act (EGTRRA) of 2001 and the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003 were not fully offset, which represented a significant decline in fiscal revenues.

Moreover, as William E. Scheuerman noted in his book, periods of "crises and emergencies"²¹ and critical events such as "September 11, a natural disaster like Hurricane Katrina, and the 2008 global financial emergency"²² generated significant growth in the discretionary executive power that contributed to the problem of increasing deficits and debt.

During the period between 2008 to 2015, the Financial Crisis and the Great Recession were the main drivers of larger deficits and debt measured as a share of the economy. In that regard, CBO reported in 2010 that the steep increase in debt of approximately 25% of GDP that

¹⁷ Tempalski, Jerry, "Revenue Effects of Major Tax Bills" U.S. Department of Treasury.

¹⁸ The period with fiscal surplus was between 1998 and 2001.

¹⁹ Congressional Budget Office. "Budget and Economic Outlook 2016-2026 Historical Tables." (Retrieved July 2, 2019).

²⁰ Ibid.

²¹ William E. Scheuerman, "Emergencies, executive power, and the uncertain future of US presidential democracy," *Law & Social Inquiry* 37, no. 3 (2012), 743–67.

²² Scheuerman, *Emergencies, executive power, and the Uncertain future of US presidential democracy*, 743.

was observed that year due to larger fiscal deficits, and, more importantly, to the financial crisis, the deep economic recession, and the policy responses to those developments.²³ In line with the CBO analysis, the fiscal year 2010 (FY2010) closed with a total-debt-to-GDP ratio of 60.9%.²⁴ Since then, debt has risen to 79% of GDP by the end of 2019 fiscal year.

The rise (and partial fall) of the \$1 trillion deficit

Regarding the increased use and cost of discretionary tools to deal with the Great Recession, more than \$1.5 trillion in stimulus was allocated during and after the 2007–2009 Great Recession. The table below shows how the Recovery Act of 2008, the American Recovery Act (ARRA) enacted one year later, and other post-recovery actions enacted between 2009 and 2012 caused the deficit to record \$1.3 trillion in 2010 and \$1.1 trillion in 2012. Among the major tax cuts implemented during the years of the recession, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 can be highlighted and let a cost of \$858 billion over 10 years; in addition, the American Taxpayer Relief Act of 2012 added a significant \$3.9 trillion cost for the same period, and the Protecting Americans from Tax Hikes of 2015 added another 10-year cost of \$680 billion.²⁵

²³ Congressional Budget Office. “Federal Debt and the Risk of a Fiscal Crisis.” (July 2010). 2. <https://www.cbo.gov/publication/21625>. (Retrieved February 11, 2020).

²⁴ Congressional Budget Office. “Federal Debt and the Risk of a Fiscal Crisis.” (July 2010). 2. <https://www.cbo.gov/publication/21625>. (Retrieved February 11, 2019).

²⁵ Committee for a Responsible Federal Budget, “The Decade in the Federal Budget,” December, 2019, <http://www.crfb.org/blogs/decade-federal-budget>, accessed February 6, 2020.

Fiscal Stimulus During and After the Great Recession

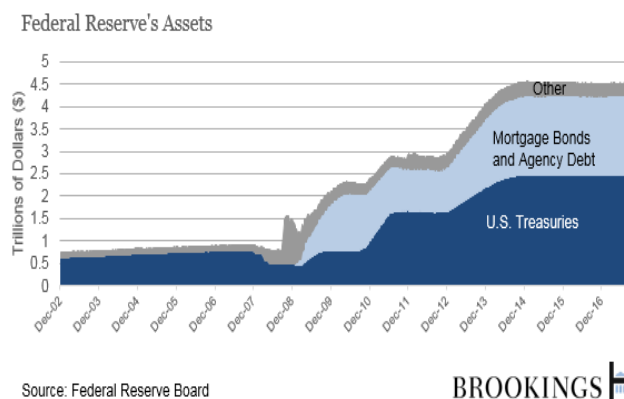
<i>Legislation</i>	<i>Year of Enactment</i>	<i>Stimulus through 2012 (\$ billions)</i>
Pre-Recovery Act		
Economic Stimulus Act	2008	138
Supplemental Appropriations Act	2008	13
Housing and Economic Recovery Act	2008	11
Unemployment and Compensation Extension Act		
Recovery Act	2008	6
American Recovery and Reinvestment Act	2009	712
Post-Recovery Act		
Supplemental Appropriations Act	2009	3
Worker, Homeownership, and Business Assistant Act	2009	35
Defense Appropriations Act	2009	18
Temporary Extension Act	2010	9
Hiring Incentives to Restore Employment Act	2010	13
Continuing Extension Act	2010	16
Unemployment Compensation Extension Act	2010	33
FAA Air Transportation Modernization Act		
Small Business Jobs Act	2010	26
Tax Relief, Unemployment Reinsurance Authorization, and Job Creation Act	2010	68
VOW to Hire Heroes Act	2010	309
Temporary Payroll Tax Continuation Act	2011	0
Middle Class Tax Relief and Job Creation Act	2011	28
Total	2012	98
		1,537

Source: Council of Economic Advisers (2014), and Congressional Budget Office.

The problem with accommodative monetary policy during (and after) the Great Recession

In addition to these increased costs, part of the discretionary power gained by the government during the years of the recession was, and still is, reflected through some sort of unconventional monetary policy, judging from the Federal Reserve interventions in the market. The graph below shows how assets held by the Federal Reserve have significantly grown since the 2007–2008 financial crisis and the Great Recession through its purchases of U.S. Treasury bonds and mortgage-backed securities issued by federal-chartered enterprises such as Fannie Mae and Freddie Mac. In other words, monetary financing of federal deficits in those years took place via

a new concept that emerged from the crisis, namely quantitative easing, or simply called “QE,” in which the Federal Reserve purchases a predetermined amount of financial instruments issued by the U.S. Treasury. Those resources are finally received and spent by the federal government in different programs that impact positively on household consumption.



Moreover, it is noticeable that, after the recession, the government continued using the monetary policy authority for fiscal spending purposes. Many of the “temporary” stimulus initiatives have been extended permanently (e.g., child tax credit, Pell grants expansions, bonus depreciation), possibly due to the need for an aggressive monetary policy contributing to a “continuous stimulus” of aggregate demand in the economy.

The efforts to lower \$1.0 trillion deficits and higher debt (2010-2015)

As the CRFB stated in a note last year, “2010 represented a high-water mark for discretionary spending in real dollars. Then, the Budget Control Act (BCA) of 2011, the major piece of deficit reduction legislation enacted this decade, reduced and capped discretionary spending for 10 years.”²⁶ The BCA also included a mechanism to increase the debt limit. In general, the BCA was the legislative result of extended budget policy negotiations between congressional leaders and President Barack Obama. On the revenues side, there was a more moderate tax increase

²⁶ Committee for a Responsible Federal Budget, “The Decade in the Federal Budget,” December, 2019, <http://www.crfb.org/blogs/decade-federal-budget>, accessed February 6, 2020.

mechanism, with no change in the corporate tax rate because of the situation about the economic recession. Moreover, President Obama's American Taxpayer Relief Act of 2012 included the expiration of the set of tax cuts for high-income earners approved in during the President George W. Bush administration.

Regarding its main objective, the BCA was originally projected to reduce the deficit by roughly \$1.9 trillion between FY2012 and FY2021, not counting subsequent modifications. In addition, under the BCA, discretionary spending was projected to average 6.4% of GDP from FY2012 to FY2021.²⁷

In terms of these two initial components, the legal instrument set discretionary spending caps that came into effect in the fiscal year of 2012, and a \$1.2 trillion spending reduction that was initially scheduled to come into effect in 2013. However, this additional component met with some problems in its implementation after a congressional "Super Committee" failed to negotiate the \$1.2 trillion saving.²⁸

One of the drivers of the difficulties in executing the bill effectively relates to subsequent legislation that was initiated in the following years. Insight into the legislative changes to the BCA is crucial to understand the persistent higher deficits and debt over the first half of the last decade. For instance, the American Taxpayer Relief Act (ATRA) of 2012, "also called the sequester, reduced and postponed the start of the FY2013 spending reductions."²⁹ In addition, the Bipartisan Budget Act of 2013 increased the discretionary spending caps in FY2014 and FY2015 and extended mandatory sequestration through FY2023. Finally, the Bipartisan Budget Act (BBA) raised the discretionary spending caps in FY2016 and FY2017 and extended mandatory sequestration.

²⁷ Congressional Research Service, "The Budget Control Act of 2011 as Amended: Budgetary Effects." <https://fas.org/sgp/crs/misc/R42506.pdf> December 29, 2015. Retrieved February 20, 2020.

²⁸ Ted Barret, Kate Bolduan, and Deidre Walsh. CNN. <https://www.cnn.com/2011/11/21/politics/super-committee/index.html> (November 21, 2011) Retrieved February 16, 2020.

²⁹ Congressional Research Service, The Budget Control Act of 2011 as Amended: Budgetary Effects.

Therefore, as the CRFB stated, “those changes around the BCA partially rolled back the sequester,”³⁰ complicating the task of decreasing the deficit figures.

However, the initiatives described above did contribute to decrease the deficit down to \$680 billion in 2013 and \$442 billion in 2015. The number of debt-to-GDP ratio was less positive. Despite negotiations between Congress and the executive branch, the outstanding debt calculated as a share of the economy went from 60.9% to 76.6% of GDP in 2016.

The return of the \$1.0 trillion deficit in the midst of economic expansion

Since 2017, deficit-increasing legislation along with other factors caused deficits to increase once more. Changes in legislation, namely the 2017 Tax Cuts and Jobs Act (TCJA) and the 2018 Spending Bill, introduced significant costs in terms of increased spending and lower revenues without the corresponding offsets. According to recent calculations by the CRFB, the two bills would cost \$2.2 trillion, but, if the temporary elements become permanent, the two laws would amount to \$5.5 trillion in costs through 2029, which is equivalent to one-third of total deficits.³¹ On the tax side, the TCJA predominates the spirit of President Reagan’s supply-side policies, given a significant decrease in the corporate tax rate from 35% to 21%, while some deductions and credits were reduced or eliminated. Also, the TCJA imposed a new territorial tax system instead of the global tax scheme.

The budget agreements of 2018–2019, which fully repealed the sequester with the consequent increase in spending and without any compensation through another policy initiative different from a higher debt, is one of the factors contributing to a growing deficit in the 2017–2019 period. Regarding the first budget agreement of 2018, the CRFB projected an increase in discretionary spending caps in the 2018–2019 period of \$165 billion for defense and 131\$ billion

³⁰ Committee for a Responsible Federal Budget, “The Decade in the Federal Budget,”

³¹ Committee for a Responsible Federal Budget, “Tax Cut and Spending Bill Would Cost \$5.5 Trillion Through 2029.” February 27, 2019. <http://www.crfb.org/blogs/tax-cut-and-spending-bill-could-cost-55-trillion-through-2029> (Retrieved February 19, 2020).

for non-defense spending.³² Moreover, the 2019 budget agreement, which would raise the caps on discretionary spending for this year and FY2021, implies a total cost of \$320 billion over the next two years against \$55 billion in offsets over the next 10 years and \$1.7 trillion in extra debt during the same period.³³

A different perspective of the problem of the U.S. deficits and debt

Despite the risks and costs related to the current dynamics regarding the federal deficits and debt, there are some scholars and think tanks that present a non-alarming perspective of the problem. For instance, in a report released last year by the Center on Budget and Policy Priorities (CBPP), the authors concluded that the long-term outlook around the federal budget has improved due to better prospects regarding health costs and lower interest debt payment given the lower market interest rates.³⁴ In addition, the authors predict that the debt-to-GDP ratio would grow at a stable rate over the next 25 years. To arrive at those conclusions, the CBPP compared the 2010 projections for the debt-to-GDP ratio to the latest forecast by the think tank and found that the January 2010 projections showed that the above ratio would reach 251% of GDP in 2044, as opposed to the projections done in 2019 for that year, which set the number at 111% of GDP.³⁵

As described above, the lower debt, calculated as a share of the size of the economy, would originate from both lower health costs and lower interest debt payments due to low interest rates in the market. Regarding the first positive aspect, the CBPP notes that its 2010 projection was calculated before the Affordable Care Act (ACA) and the subsequent coverage

³² Committee for a Responsible Federal Budget, "Budget Deal Would Bust Original BCA Caps." February 8, 2018. <http://www.crfb.org/blogs/budget-deal-would-bust-original-bca-caps> (Retrieved February 19, 2020).

³³ Committee for a Responsible Federal Budget, "Five Reasons to Oppose the Budget Deal." July 23, 2019. <http://www.crfb.org/blogs/five-reasons-oppose-budget-deal> (Retrieved February 19, 2020).

³⁴ Center on Budget and Policy Priorities, "Long-Term Outlook Has Improved Substantially Since 2010 But Remains Challenging." <https://www.cbpp.org/research/federal-budget/long-term-budget-outlook-has-improved-substantially-since-2010-but-remains> October 10, 2019. (Retrieved February 22, 2020)

³⁵ Center on Budget and Policy Priorities, "Long-Term Outlook Has Improved Substantially Since 2010 But Remains Challenging."

expansions. However, the authors state in the document that the costs of those expansions were offset by a series of factors, such as “(1) the ACA’s short- and long-term reductions in Medicare payment rates to health care providers; (2) the changes in health care payment and delivery systems initiated by the ACA and the 2015 Medicare Access and CHIP Reauthorization (MACRA); and (3) the growing effects of a health cost slowdown in the public and private sectors that commenced before the introduction of the ACA.”³⁶ As a result, the 2019 projection is that health costs would be 7.9% of GDP in 2044, which represents two-thirds of the projection 10 years previously.

The second major factor driving a lower debt-to-GDP ratio, according to the CBPP report, is the low-interest-rate environment. Despite an increase in interest rates and the assumption made by the CBO in its forecast of more increases, the document highlights that the Congressional Budget Office is changing the projection of the average rate for the instruments issued by Treasury to reach 2.8% in 2029. According to the CBPP, “these significantly lower interest rates, if continued through 2044, will result in notably lower net interest costs.”³⁷

Despite the more optimistic view of the CBPP, the report warns that the projections might change dramatically if policymakers decide to further reduce revenues by making permanent or extending the 2017 tax-cut initiatives that are currently in effect. In that scenario, the CBPP would change the 2044 projection to a debt-to-GDP ratio of 139% of GDP, in contrast to the estimated 111% of GDP without these extensions in current legislation

³⁶ Ibid. 9.

³⁷ Ibid.

Why is it being done it this way?

Apart from political-economic considerations, the dynamics around federal spending and revenues have changed since the 2007–2008 financial crisis, given the re-appearance of a phenomenon known as “secular stagnation.”³⁸ In this scenario, the domestic demand tends to be below the required level, which, in combination with low interest rates, limit the power of the Federal government to stimulate the economy. Therefore, some type of ongoing fiscal stimulus is needed (as opposed to only during a recession). Given the necessity of a fiscal program that can satisfy domestic demand, it seems likely that deficits and debt are driven by domestic-affair events, even though the economy is no longer in a recession.

Furthermore, aging population might also explain increasing deficits and debt. In 2018, Callum Jones studied the problem of secular stagnation and the business cycle of the U.S. economy, including some demographics and the lower interest rates scenario. After developing his model, he found that the aging of the general population explains a significant proportion of the decline in the GDP per capita relative to the pre-crisis trend, causing or contributing to a slow recovery after the Great Recession.³⁹ Given the problems of lower productivity and increased social security demands derived from this demographic variable, higher financing requirements should be considered for the government to keep the economy above the levels recorded during the recession years.

Why is the current policy not working?

The overarching conclusion is that current policy is not working because, by implementing the current legislation without any correction in the short-term, the long-term debt and fiscal scenario would be unsustainable. In that case, the high levels of debt would imply a substantial

³⁸ Alvin H. Hansen, *Full recovery or stagnation?* New York: W. W. Norton & company, inc, 1938.

³⁹ Callum Jones, *aging, secular stagnation and the business cycle* (Washington, D. C.: International Monetary Fund, 2018).

decline in economic activity, a large increase in interest rates, and an explosive situation regarding federal debt interest payments. In other words, if policymakers should oppose action to prevent this debt accumulation, a fiscal crisis could force corrective and painful action. Moreover, the negative trend around large deficits and debt is not justified, in the light of the economic expansion reported in the last three years.

Despite the fact that economy is not facing inflationary pressures, a possible overheating of the economy could cause the Federal Reserve to decrease the use of a more accommodative monetary policy, for example, through a deceleration of the “quantitative easing.”

In addition, under the current fiscal environment, a new financial crisis would find the federal government with less “fiscal space” to deal with it, in comparison with the 2007–2008 crisis, unless the Federal Reserve decides to print more money to bail out financial entities such as Fannie Mae and Freddie Mac, corporations, and other companies, with dramatic consequences in terms of inflation.

Moreover, in the event of this restriction of the government, the Federal Reserve would be obliged to increase interest rates, which could negatively impact the housing finance market and homeowners would face foreclosure, given the absence of either an explicit or implicit federal guarantee, due to the lower fiscal space mentioned above.

Clearly, under the current situation with the Federal Reserve interest rates at extremely low levels, the monetary authority would not have any degree of freedom to stimulate the economy during a financial crisis and possible recession via new interest rate cuts. These almost-zero rates would not have the desired impact on the housing finance market or on private investment.

Delaying policy decisions would make future adjustments more costly.

Regarding the delay in correcting the deficits and debt problem, the 2019 CBO annual report estimates that the adjustments could grow by 50% if the policy decisions are delayed by 10 more years. In this regard, the CRFB highlights that maintaining a high debt-to-GDP ratio for the next thirty years would require spending cuts or an increase in revenues equivalent to 1.8% of GDP, if the government starts adjusting in 2020. Moreover, if the adjustment only starts 10 years later, the cost of the adjustment will increase by 0.9 percentage points to 2.7% of GDP.⁴⁰

Another note released by the CRFB in June 2019 cites the CBO projection as one of the possible outcomes if policymakers start correcting the debt problem. In this case, the conclusion is that income per capita could be approximately \$9,000 higher in 2049 if the problem with debt is corrected, in comparison with a scenario in which current policy remains unchanged.⁴¹

Another economic argument to explain how current policy is not working might be seen in one CBPP report published in November last year that offers an insightful depiction of the risks from current legislation. In the report, the author states that there has been a turning point affecting a trend that the U.S. used to record since 1965, in which higher unemployment rates were followed by larger deficits. However (see table below), under the current 3.6% unemployment rate and a more favorable economic environment, the average deficit is similar to that reported with a higher unemployment and a lower GDP growth rate. The report concludes that the change around the trend described above relates to a change in the federal receipts function which “has been partially dismantled by the 2017 tax cuts.” Moreover, the CBPP report

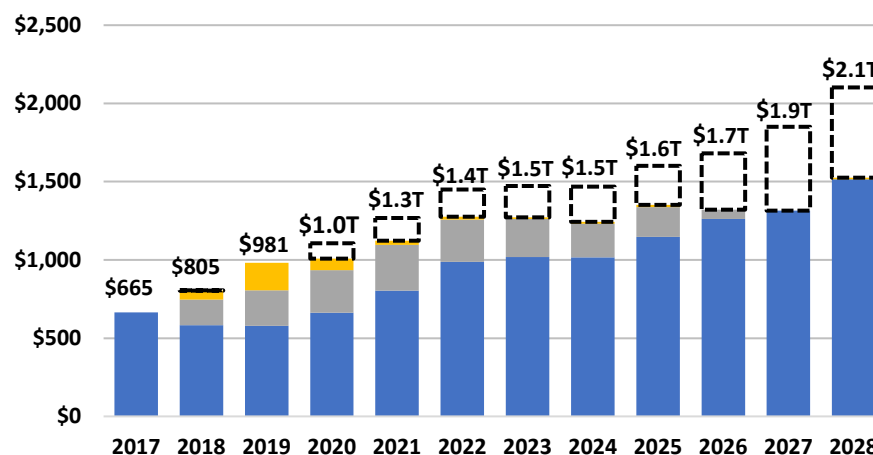
⁴⁰ Committee for a Responsible Federal Budget. “Analysis of CBO’s 2019 Long-Term Budget Outlook.” (June 2019). Retrieved February 14, 2020).

⁴¹ Committee for a Responsible Federal Budget. “CBO: Fixing the Debt Would Increase Income.” (June 2019). <https://www.crfb.org/blogs/cbo-fixing-debt-would-increase-income>.

warns that federal budget deficits with lower unemployment in the economy will put more pressure on interest rates.

To conclude this section, the graph below shows an informative CRFB analysis of the fiscal environment in the coming years that includes the effects of the 2017 Tax Bill and Jobs Act, the 2018 Spending Bill, and assumes that current legislation is extended. Under these conditions, the deficit would go from \$663 billion in 2020 in a scenario that excludes the effects of the bills and its extension to a worrisome \$1 trillion deficit when including the effects of the bills and the extension of current legislation.

Deficit Estimates including 2017 TCJA and Extension of Current Legislation
(Billions of Dollars)



Source: CRFB.

Note: The blue bar measures the deficit figure without current legislation. The grey bar includes the effect of the 2017 TCJA, and the dotted bars measure the effect of the extensions.

By a similar token, the 2028 projection of deficit figure without including the effects and extension of current policy would be \$1.5 trillion against a new record of \$2.1 trillion deficit under the scenario that assumes current legislation and the extension in the coming years.

As we can see from the most recent historical facts, the near-term drivers of deficits and debt are making the long-term fiscal scenario unsustainable. For that reason, the following proposal will

focus on those short-term events with the objective to stabilize deficits and debt over the next ten years.

Policy Proposal

The proposal is to *increase the statutory corporate tax rate from the current 21% to 25%*. The objective is to lower the fiscal deficit by \$500 billion over 10 years, which is equivalent to one percentage point of the debt-to-GDP ratio. The initiative would also allow policymakers to manage deficits below the \$1 trillion mark over the same period. The initiative proposed would cut the debt ratio by 5% of GDP by 2050.

General description of the proposal

The corporate income tax rate

The corporate income tax generally applies to C corporations, also known as regular corporations. These corporations—named for Subchapter C of the Internal Revenue Code (IRC), which details their tax treatment—are generally treated as taxable entities separate from their shareholders. Corporate taxpayers are allowed to claim a 20% deduction from certain income earned through pass-through activities.

The corporate income tax is designed as a tax on corporate profits (also known as net income).

A corporation's tax liability can be calculated as follows:

$$\text{Taxes} = [(\text{Total Income} - \text{Deductible Expenses}) \times \text{Tax Rate}] - \text{Tax Credits}.$$

The current corporate income tax rate is a flat 21%. Thus, tax liability before applying tax credits is generally calculated as 21% of taxable income. Corporate tax liability can be reduced by claiming corporate tax credits. In broad economic terms, the base of the corporate income tax is the return to equity capital.

Authorizing mechanism

The current federal corporate tax rate was signed into law under the act to provide for reconciliation, pursuant to titles II and V of the concurrent resolution on the budget for FY2018, known as the Tax Cuts and Jobs Act (TCJA). In that sense, the legal authority to proceed with the proposed adjustment would be Congress, which has to make the corresponding amendment to the IRC of 1986 and the necessary change in the Subtitle C—Business-related Provisions, PART I—CORPORATE PROVISIONS, section SEC. 13001. 21% CORPORATE TAX RATE, increasing the current 21% rate to a new corporate tax rate of 25%.

What is the time frame for adopting the proposal as policy?

As it will be analyzed with more details in the political analysis section, the policy proposal must take into account the reality of the legislative arena throughout 2020. First, after the Democratic Party made the case for an impeachment of President Donald Trump, in which he was acquitted, and the upcoming presidential election on November 3rd, the most likely scenario is that the proposal to increase the corporate rate tax will face strong opposition and debate by the Republican Party, which traditionally has been reluctant to approve higher tax rates for corporations. Second, it is also important to understand that much of the 2020 legislative agenda is already set and deeply focused on the crisis about the coronavirus pandemic, which leaves no room for the discussion of the proposal. In that sense, a suitable time frame to propose and start debating it could be in the current 116th Congress because, despite the low probability of obtaining approval this year, the Democratic Party could propose this kind of change to the legislation to use it as a “message” piece for 2020 voters. Moreover, since both parties want to control the next Congress, the proposal could assist in convincing voters to support the Democrats through the early differentiations of the visions of the parties regarding the future of the country’s tax system, especially in 2021, or once the economic effects of the coronavirus pandemic be

controlled thanks to the set of initiatives that will male fiscal deficit and debt figures to go up dramatically.

Policy Implementation:

The Treasury Department will issue the new corporate tax rate, and the Internal Revenues Service (IRS) will enforce it. After collecting the corresponding tax receipts, the IRS will turn collected taxes over to the U.S. Department of Treasury.

Who would be target?

The main and direct target of the 25% corporate tax rate is corporate profits. The new corporate tax rate will also affect all American families since new or current programs that benefit households will have more resources to facilitate implementation. Also, from the technical point of view, due to its simplicity and the fact that the policy proposal adjusts the corporate tax rate and not the authorizing mechanism, the implementation of the policy does not incur any cost for the government in the short term. However, as we will see with more detail in the policy analysis section, there are some costs related to the approval of the policy proposal. For instance, even though the increase of the corporate tax rate might generate public savings in excess of \$500 billion over 10 years, there is a set of distortions caused by a higher corporate tax rate in terms of organizational structure, the investment financing mechanisms, as well as some costs that will be see in lower economic growth and employment in the long run. For example, the Tax foundation estimates that the size of GDP could lower by 0.87% in the long run which would lead to “175,700 fewer full-time equivalent jobs.”⁴²

⁴² Erica York, “The Benefits of Cutting the Corporate Income Tax Rate,” The Tax Foundation, accessed March 3, 2020, https://files.taxfoundation.org/20180813165516/The-Benefits-of-Cutting-the-Corporate-Income-Tax_FF606.pdf. 6.

Policy Analysis

Benefits from the adjustment of the corporate income tax rate

Restoring the corporate tax rate from 21% to 25% would be more effective than similar policy options, such as the repeal of the Targeted Corporate Tax Break. In the first option, the CRFB estimates that the adjustment of the corporate rate from 21% to 25% would lower the deficit by up to \$500 billion over 10 years, which is equivalent to a one-percentage point reduction in the debt-to-GDP ratio. Beyond the 10-year horizon, the CRFB estimates that the effect of the adjustment in the corporate tax rate on the total debt-to-GDP ratio would be equivalent to a five-percentage point reduction by 2050. In contrast, an alternative policy option consisting of the repeal of the Corporate Tax Breaks could lower the deficit by \$140 billion over the next 10 years, while decreasing the debt as a share of GDP by 2050 by only two percentage points.⁴³ Simply put, public savings measured in terms of the lower deficits under the first option would be higher than those from a policy that eliminates a “number of tax breaks at specific industries, including fossil and renewable energy production, low-income households, life insurance, and credit unions.”⁴⁴

In addition, the CBO highlights that the most relevant argument supporting the adjustment in the corporate income tax rate relates to its simplicity. Last year, the federal agency above within the legislative branch estimated that increasing the corporate income tax rate by one percentage point would have increased revenues by \$96 billion from 2019 to 2028, if the option came into effect in January 2019.⁴⁵

⁴³ Committee for a Responsible Federal Budget, “The Debt Fixer,” accessed March 1, 2020, <http://www.crfb.org/debtfixer/>.

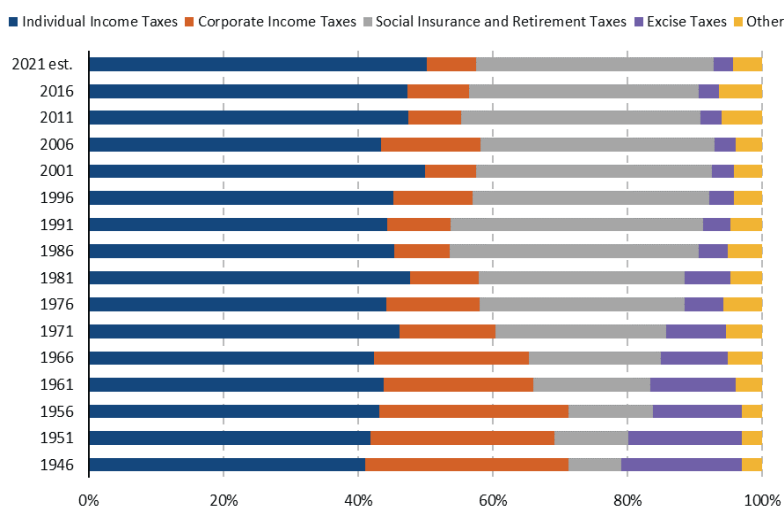
⁴⁴ Committee for a Responsible Federal Budget, “The Debt Fixer.”

⁴⁵ Congressional Budget office, “Options for Reducing the Deficit: 2019 to 2028,” last modified December 13, 2018, accessed July 6, 2019, <https://www.cbo.gov/publication/54667>.

Another benefit from the adjustment in the corporate tax rate is that it is widely viewed as a progressive policy tool that raises revenues without affecting workers. With the burden of the tax spreading to all owners of capital and analyzing the incidence of the corporate tax, the Congressional Budget Office and the Joint Committee on Taxation tend to mostly distribute the burden to the owners of capital, who tend to be in the higher income group, with a smaller fraction falling on labor income.⁴⁶

Regarding the empirical assessment that favors the proposed policy, the Congressional Research Service highlights a significant change in the composition of revenues over time (see chart below), in which corporate tax revenues represent a smaller share of overall tax revenues relative to other concepts that contribute a larger share of those revenues. For instance, the corporate income tax was estimated at \$216 billion in revenue during the FY2019, which is equivalent to 6% of total revenues. Instead, social insurance or payroll taxes were estimated at \$1.2 trillion, which makes up 36% of total revenue in the same fiscal year.

Composition of Federal Revenue (Selected Years 1946–2021)



Source: CRS calculations using data from U.S. Office of Management and Budget, *Budget of the U.S. Government, FY2020, Historical Tables* (Washington: GPO, 2019).

⁴⁶ Molly F. Sherlock and Donald J. Marples, "Overview of the Federal Tax System in 2019," last modified November 20, 2019, accessed March 4, 2020, <https://fas.org/sgp/crs/misc/R45145.pdf>.

The change in the composition of revenues reported over the last two years was also fueled by the corporate tax rate cut of 2017, established at 21%, and this seems to be adding more to deficits than what experts had projected. Simply put, lower corporate tax rates led to a decline of corporate tax receipts by about as much as the deficit. For instance, corporate tax receipts fell by approximately \$90 billion between FY2017 and FY2018, a figure that is equivalent to 80% of the increase in the deficit recorded in that period.⁴⁷

Another argument in favor of a higher corporate income tax rate will prevent corporations to use the tax system to shield their income. For instance, the Center for Budget and Policy Priorities (CBPP) concluded that this kind of tax cut benefits the wealthiest, loses much-needed revenue, and encourages tax avoidance.⁴⁸ In the document, CBPP cites a study from the Tax Policy Center in which the share of benefits was calculated by income group, finding that the top 1% of households receive 34% of the benefits.⁴⁹ Regarding the losses in the required fiscal revenue, the CBPP references the analysis of the corporate tax cut by the Joint Committee on Taxation, which concludes, after some calculations, that, after provisions, the net corporate tax cut is equivalent to \$329 billion in lost revenue. In addition, the CBPP concludes that the corporate tax rate cut creates income that is sheltered by “setting up a corporation and reclassifying income as corporate profits.”⁵⁰ In this way, corporations will use this mechanism as a shield to defer their taxes for decades.

47 Hendricks Galen, Seth Hanlon, and Michael Madowitz, “The TCJA 2 Years Later: Corporations, Not Workers, Are the Big Winners,” last modified September 26, 2019, accessed February 24, 2020, <https://www.americanprogress.org/issues/economy/news/2019/09/26/475083/trumps-corporate-tax-cut-not-trickling/>.

48 Center on Budget and Policy Priorities (CBPP), “Corporate Tax Cut Benefits Wealthiest, Losses Needed Revenue, and Encourages Tax Avoidance,” last modified June 13, 2018, accessed February 28, 2020, <https://www.cbpp.org/research/federal-tax/corporate-tax-cut-benefits-wealthiest-loses-needed-revenue-and-encourages-tax>.

49 Tax Policy Center, “T17-0180 – Share of Change in Corporate Income Tax Burden; By Expanded Cash Income Percentile, 2017,” last modified June 6, 2017, accessed February 28, 2020, <https://www.taxpolicycenter.org/model-estimates/distribution-change-corporate-tax-burden-june-2017/t17-0180-share-change-corporate>.

50 Center on Budget and Policy Priorities (CBPP), “Corporate Tax Cut Benefits Wealthiest, Losses Needed Revenue, and Encourages Tax Avoidance.”

Likewise, since corporations are currently receiving additional benefits related to the TCJA, the proposed increase of the corporate income tax rate might be offset over the next four or five years. As the CBO showed in its 2018 report regarding the effects of the 2017 TCJA, domestic corporate profits will be 7.1% higher over 10 years because, among other factors, corporations are now allowed to hold debt in the U. S. to finance domestic investment. In that sense, and due to the process of repatriating profits, corporations will be allowed to reduce their debt and interest payments, suggesting that the proposed 25% rate should not impact corporations dramatically.⁵¹

On the legal front, an increase in the tax rate to 25% will not affect the way U.S. multinationals plan for their intangible income.⁵² For instance, one argument supporting the statement above is that the 2017 TCJA section devoted to corporate businesses made significant changes to both the treatment of multinational corporations and their sources of income from abroad, which are now exempt under the concept of “territorial system.” Under the new system enacted in 2018, the Global Intangible Low-Taxed Income (GILTI) is included in the current gross income of a U.S. shareholder of any foreign corporation, while allowing for a 50% deduction through 2025 and 37.5% in the following years.⁵³ In addition, the TCJA provides a new element for the taxation of foreign intangible income (FDII) that states that the beneficial rate on FDII achieved through a deduction scheme. Due to these deductions and the use of new foreign tax credits paid in respect of the GILTI, the effective rates will be below 13.125% through 2025 and near 16.4% thereafter for additional U.S. tax. The conclusion regarding this first argument is that

51 Congressional Budget Office. “The Effects of the 2017 Tax Act on CBO’s Economic and Budget Projections.” Last modified April, 2018. Accessed April 22, 2019. <https://www.cbo.gov/sites/default/files/115th-congress-2017-2018/reports/53651-outlook-appendixb.pdf>

52 *intangible income* is the income exceeding a *deemed tangible income return* equal to 10% of qualified business asset investment (“QBAI”). (In the case of intangible income earned offshore, the tangible return is reduced by allocable interest expense, resulting in a *net deemed intangible income return*.)

53 Kurt Wulfekuhler, “What Happens If the U.S. Tax Rate Goes Up?” Accessed February 29, 2020, <https://www.econpartners.com/2018/03/15/corporate-tax-rate/>.

an increase in the corporate tax rate from 21% to 25% does not change the current deductions for both GILTI and FDII or the addition of GILTI in the context of current gross income. According to certain legal tax experts, “the effective rate on *both* FDII and GILTI would be 15.625% through 2025 and roughly 19.5% thereafter,”⁵⁴ which suggests that the distortion caused by the rate adjustment should not exert a great impact on the effective rate paid by corporations.

The second argument is that the 2017 tax system ensures parity on the taxation of GILTI and FDII. In line with the policy goal expressed in the new tax system, the legal expert Kurt Wulfekuhler contends that it would be a mistake to assume that the intangible income earned by non-U.S. members of the group will look to other mechanisms to protect themselves from a higher corporate tax rate, given the clear objective in the law to tax FDII and GILTI at parity. While the increase in the corporate tax rate from 21% to 25% will affect FDII benefits, it will also increase the tax burden of GILTI, which implies that U.S. multinationals will continue to be interested in the benefits of onshoring.

Drawbacks of higher corporate income tax rates

The case for a large corporate tax cut as the one included in the 2017 Tax Bill was based on a series of arguments around global competitiveness, efficiency, and its effect on financial decisions made by corporations. For instance, defenders of the corporate tax rate cut from 35% to 21% argued that it was required to keep the United States competitive, as the U.S. corporate tax rate was far higher than that of other countries. In addition, agencies such as the CBO noted that one argument against the increase in the corporate income tax rate is that “it would reduce economic efficiency by exacerbating tax-related distortions of firms’ decisions.”⁵⁵ Simply put, the

⁵⁴ Wulfekuhler, “What Happens If the U.S. Tax Rate Goes Up?”

⁵⁵ Congressional Budget office. “Options for Reducing the Deficit: 2019 to 2028,” 267.

distortion caused by a higher corporate tax rate relates to the way corporations reorganize their organizational structure and the instruments they use to finance investments. Regarding the impact on financial decisions, the higher corporate income tax rate would increase the value of deductions, causing companies to obtain financial resources via “debt financing,” because they will be able to deduct the interest payments.⁵⁶ Due to this effect of the higher tax rate, corporate debt might increase because of the long-lasting effect of the higher tax rate on financial decisions, which also increases the default risk over time.

Another argument against high corporate tax rates is that corporations will consequently make use of more tax credits. Even though the Joint Committee on Taxation estimates that a one-percentage increase in the corporate tax rate would increase revenues by \$96 billion from 2019 to 2028, the CBO raises the alert on the changes around the tax credits associated with an increase in the tax rate for corporations. In that sense, the CBO states that companies will make more active use of credits that tend to reduce the effective amount of fiscal revenues associated with the higher tax rate.⁵⁷ The other valid argument that the CBO raises against the proposal to increase the corporate tax rate is that corporations will change their preferences in terms of origin of earnings. In other words, a new hike in the corporate tax rate would make it less appealing to earn income in the U.S. relative to earning income abroad.⁵⁸

Regarding the negative macroeconomic effect of a higher corporate tax rate, the Tax foundation estimates that the size of GDP could lower by 0.87% in the long run which would lead to “175,700 fewer full-time equivalent jobs”⁵⁹ if the tax rate is adjusted to 25%, as is proposed in the present memorandum. Continuing the economic analysis by the Tax Foundation, it also

⁵⁶ Ibid.

⁵⁷ Ibid.

⁵⁸ Ibid., 267.

⁵⁹ Erica York, “The Benefits of Cutting the Corporate Income Tax Rate.”26.

concludes that the TCJA would cause wages to grow 1.5% in the long-run model developed by the think tank, while the capital stock could record a 4.8% growth rate, with the corporate tax rate cut as one of the strongest factors to explain these positive figures. In addition, the Tax Foundation contends that the lower corporate tax rate works in favor of competitiveness. Their argument is that, with the 21% rate, the U. S. corporate income tax rate is now closer to the median of the OECD countries' corporate tax rates, encouraging other countries to move away from high taxes on capital gains toward more competitive corporate income tax rates.

Another argument against higher corporate tax rates relates to the negative impact on the effective corporate tax rate. Economist Casey Mulligan from the University of Chicago contends that corporations have paid a low effective tax rate due to the damage caused by the tax during the years before the implementation of the 2017 TCJA and not because of the argument of the defenders of corporate tax rate increases that states that corporations end up paying a low corporate tax rate due to a "free-lunch behavior at the government's expense." In line with his approach, Mulligan states that the damage above relates to the process businesses face to comply with the law "and pay by accepting comparatively low-return investments."⁶⁰ He also states that the effective rate only counts in the form of payments made to government. In other words, by having so many deductions, the corporate tax involves a substantial hidden tax on businesses beyond what they pay the government, with the extra payment in terms of lost income, suggesting that a cut in the corporate tax rate will improve economic performance "far more than it will cost government treasury."⁶¹

⁶⁰ Casey B. Mulligan, "Low effective corporate rate not an argument against tax cut," last modified November 13, 2017, accessed March 5, 2020, <https://thehill.com/opinion/finance/360148-low-effective-rate-not-an-argument-against-corporate-tax-cut>.

⁶¹ Mulligan, "Low effective corporate rate not an argument against tax cut."

The CBO also showed in a 2018 report concerning the effects of the 2017 TCJA, that domestic corporate profits will be 7.1% higher over 10 years, because, among other factors, corporations are now allowed to have debt held in the U. S. to finance domestic investment.⁶² In that sense, due to the process of repatriating profits, corporations will be able to reduce their debt and interest payments. Simply put, a lower corporate income tax rate would also diminish a distortion in terms of debt accumulation and risk of default over time.

In an empirical research study Alan Auerbach estimated average annual tax rates for U.S. non-financial corporations and compared taxes paid on domestic earnings to income from the National Income and Product Accounts, for the 1993–2003 period. He showed that corporations faced annual average tax rates that oscillated between 29.2% and 49.2%, as tax-reducing provisions (e.g., accelerated depreciation) were offset by other provisions that increased tax rates, such as the limited deductibility of net operating losses. In other words, Auerbach concluded that, even in the stage in which corporations adjusted the taxable income with provisions that tend to reduce it, relative to economic income, the final tax rate faced is not lower in comparison with the statutory 35% rate that was in effect during the period under analysis.⁶³ The higher the corporate tax rate, the higher the level of distortions faced by corporations. In addition, Auerbach contends that the current corporate tax rate at 21% provides more benefits to households, which partially offsets the costs of that tax rate in terms of revenue loss for the government. Based on a production-function approach, and assuming the average effect of the corporate tax rate cut on GDP growth at 0.6%, he found that annual labor income grows at a similar rate, which is equivalent to \$500 per household at 2018 income levels. In addition, he

⁶²Congressional Budget Office, "The Effects of the 2017 Tax Act on CBO's Economic and Budget Projections," last modified April, 2018, accessed April 22, 2019, <https://www.cbo.gov/sites/default/files/115th-congress-2017-2018/reports/53651-outlook-appendixb.pdf>.

⁶³ Alan Auerbach, "Measuring the Effects of Corporate Tax Cuts," *Journal of Economic Perspectives* 32, no. 4. (Fall 2018): 97–120.

showed that an increase in compensation for 125 million American families is equivalent to \$62.5 billion or approximately 50% of the expected revenue loss for 2020, according to JCT estimates.

Finally, there is also international evidence of the effect of higher corporate tax rates on private investment and other microeconomic variables. In a cross-country study, Simeon Djankov, Tim Ganser, Carelee McLiesh, Rita Ramalho, and Andrei Schleifer found evidence that effective corporate tax rates have “a large and significant effect on corporate investment and entrepreneurship.”⁶⁴ Using specific measures of investment, foreign direct investment (FDI), business density, and other metrics, the authors found that the results for the statutory tax rate were similar to those for effective rates in terms of the magnitude and statistical significance. The research paper concludes that a 10-percentage point effective increase in the first-year corporate tax rate reduces the aggregate investment in GDP by approximately two percentage points. In addition, a 10-percentage point increase in the first-year effective corporate tax rate reduces business density by 1.9 firms per 100 people.⁶⁵

Political Analysis

As stated in the policy proposal section, the necessary mechanism to pass the proposal into law is legislation. However, the odds of approving an increase in the corporate tax rate at some point this year are not favorable given the current crisis around the coronavirus pandemic and its impact on the economy. In addition, the legislative agenda for this year is full, and the discussion of new legislation will be focused on more fiscal stimulus, such as sending stimulus checks to American families, deferring individual tax filings, and providing financial support to including demand-supporting policies to small businesses rather than approving anti-stimuli

⁶⁴ Simeon Djankov, Tim Ganser, Carelee McLiesh, Rita Ramalho, and Andrei Schleifer, "The Effect of Corporate Taxes on Investment and Entrepreneurship," *American Economic Journal: Macroeconomics* 2, no. 3 (July 2010): 31–64.

⁶⁵ Djankov et al., "The Effect of Corporate Taxes on Investment and Entrepreneurship."

policies involving an increase in the tax rate for corporations. Moreover, given that the Republicans control the Senate and the corporate tax rate cut from 35% to 21% was one of President's Trump campaign promises that he subsequently accomplished when elected, there is a low probability of having a proposal that increases the corporate tax rate to 25% approved. In addition, no Democrat or Republican president has approved an increase in the corporate tax rate over the past 50 years. Instead, all the administrations during that period decided to lower tax rates for corporations, either to fight a recession or as part of tax reforms.⁶⁶ In addition, some polls exhibit a growing trust in corporations, which makes more difficult to see a favorable opinion from the public regarding the increase of the corporate tax rate. In 2017, a Pew Research Center survey revealed that about six-in-ten adults had a favorable opinion of business corporations, against a 48% recorded in a similar survey of March 2015.⁶⁷ Likewise, in a mid-December 2019 Gallup survey, 52% of respondents said that they have a positive view of big business, versus 50% recorded in 2018.⁶⁸

Even though a proposal to increase corporate tax rates is unlikely to pass this year, there are some reasons to make the case that it should be proposed either sometime this year or in 2021.

⁶⁶ Amadeo, Kimberly "U.S. Corporate Income Tax Rate, Its History, and the Effective Rate" The Balance. December 21, 2019. Accessed April 6, 2020, <https://www.thebalance.com/corporate-income-tax-definition-history-effective-rate-3306024>

⁶⁷ Pew Research Center, "Most Americans See Labor Unions, Corporations Favorably," January 30, 2017, <https://www.pewresearch.org/fact-tank/2017/01/30/most-americans-see-labor-unions-corporations-favorably/>

⁶⁸ Gallup, "Do Americans Like or Dislike 'Big Business'?" December 13, 2019, <https://news.gallup.com/poll/270296/americans-dislike-big-business.aspx>

The Use of the Proposal as a Political-Electoral Strategy

First, given the imminent higher deficits and debt, amid the set of fiscal packages that will be implemented in the coming months, a separate Democratic-proposed piece of legislation could serve to convey a “message” to voters.

Since the Democratic Party will want to control the next Congress, as well as the next incumbent of the White House, one way to convince voters to support them could be through highlighting the parties’ varying visions for a future of the tax system, in which, under Democratic rule, corporations would pay more taxes. Simply put, given the political cost inherent in the economic and employment effects of the Covid-19 pandemic that will be faced by Republicans, a Democratic Party strategy proposing the increase of the corporate tax rate could be politically suitable. Even in the event that the proposal does not pass in Congress this year, with the possibility that the Democrats could win the Senate and the Executive branch in the coming elections, the odds of an increase in the corporate tax rate would be higher in 2021.

The Weight of Public Opinion

The second reason to consider a proposal to increase corporate tax rates relates to public concern regarding the deficit. According to a December 2019 Pew Research Center survey, 53% of Americans believe that the federal deficit is a large problem, with only the issues of drug addiction and the affordability of health care and education having higher scores.⁶⁹ Moreover, a Gallup survey conducted in March last year reported that 52% of respondents think that President Trump’s 2017 tax cuts increased the deficit, as opposed to 46% of citizens who responded to the same question in 2003 when President George W. Bush approved a similar tax cut initiative.⁷⁰ The

⁶⁹ Pew Research Center, “In a Politically Polarized Era, Sharp Divides in Both Partisan Coalitions,” December 17, 2019. <https://www.people-press.org/2019/12/17/views-of-the-major-problems-facing-the-country/>

⁷⁰ Gallup, “Federal Budget Deficit,” March 10, 2019. <https://news.gallup.com/poll/147626/federal-budget-deficit.aspx?version=print>

low level of trust on Wall Street by Democrat and Republican Americans could represent an additional element to bear in mind in the discussion about corporate taxes. According to a CNN exit poll, just more than a half of Republicans said that Wall Street hurt the economy, while more than 6 in 10 Democrats think the same.⁷¹ In addition, while a Washington Post-ABC poll conducted on March 29 reported President Trump's approval rating for the handling of the economy at 57 percent, the evolving situation around the pandemic and its economic and social consequences might negatively affect his approval ratings in the coming months, which could lead to a higher acceptance of the proposal by the public in 2021 to resolve the problems with higher deficit and debt once the economy overcomes the recessive cycle.

Despite the favorable public opinion on deficit financing matters that could support an increase of the corporate tax rate in the future, recent lessons learned from the Democratic party's primary elections will have to bear in mind to move forward about that decision. For instance, progressive candidates like Senators Bernie Sanders and Elizabeth Warren proposed an aggressive policy against corporations in their respective campaigns but with adverse results in comparison with a more moderate Joe Biden's campaign. In general, Democrats' anti-corporate character has implied higher costs in terms of elections in the past.

The negotiation of an extension of the coronavirus relief program and the infrastructure bill

The other possibility for Democrats to have a higher corporate tax rate approved and enacted this year but delayed until 2021 (should the recession come to an end in that year) relates to President Trump's call for a new \$2 trillion infrastructure bill as the next phase of the coronavirus relief program. Moreover, in the aftermath of the crisis associated with the coronavirus pandemic, Democrats could take advantage of this new government's proposal to

⁷¹Bump Phillip, "Republicans and Democrats Agree: Wall Street is Bad," Washington Post, April 19, 2016, <https://www.washingtonpost.com/news/the-fix/wp/2016/04/19/wall-streets-home-state-hates-wall-street/>

promote a rapid economic and employment rebound via infrastructure programs without approving a “blind check” to the President, as it occurred with the approval of the first relief package that is mainly financed via Federal Reserve. Moreover, the Democratic party could place previous Democrat proposals on infrastructure on the table that could be discussed with Republicans in Congress and the government. For instance, in March 2018, Senate Democratic leaders announced their Jobs and Infrastructure Plan which involves spending more than \$1 trillion on public infrastructure by 2028.⁷² Among the provisions to fund the proposed infrastructure spending, an increase in the corporate tax rate from 21% to 25% was proposed. In 2018, the Senate Democrats estimated that this new rate would generate \$359 billion in revenue over the next 10 years.

In this way, the Democratic Party could negotiate the approval of the infrastructure bill by including the adjustment of the corporate tax rate. The political negotiation should involve proposing that the new rate be enacted this year but delaying implementation until 2021 or until the economy recovers from the recession. Given the economic impact of the situation around the pandemic, the tradeoffs policymakers might be willing to accept might be politically feasible. Otherwise, it will take more time to negotiate the second phase of the coronavirus relief program with the House of Representatives. In addition, by proposing a higher tax rate for corporations as one of the conditions to approve the infrastructure bill, the Democratic Party will have more leverage with which to influence policymakers.

⁷² Penn-Wharton Budget Model, “The Jobs and Infrastructure Plan for America’s Workers,” University of Pennsylvania. May 21, 2018.
<https://budgetmodel.wharton.upenn.edu/issues/2018/5/14/jobs-and-infrastructure-plan-for-americas-workers>

Statements by politicians and advocacy groups:

The moderate and progressive wings of the Democratic Party agree on increasing taxes on the wealthy and corporations while providing relief to the middle class. As seen in previous months, the 2020 Democratic presidential candidates rolled out scores of tax proposals identifying their goals and what they will seek to achieve if they defeat President Trump and win the executive branch.⁷³ In the case of former Vice President Joe Biden, even though he is pushing for a smaller expansion of government, his campaign estimates that it would raise \$3.4 trillion over 10 years from Biden's tax plans, among which the repeal of President Trump's tax cuts is highlighted, with a new corporate tax rate of 28%. Given the dynamics that are likely to be recorded in some political polls in the coming months, with a possible deterioration in President Trump's approval rates associated with the economic impact of the pandemic, the Democrats could take advantage by proposing the policy proposed in this memo, again, as messaging pieces for voters in November.

In addition, Michael Linden, executive director of the progressive Groundwork Collaborative, said that it would be reasonable to consider a return to a 35% corporate tax rate. Regarding this point, he contends that the 2017 TCJA didn't do anything except pad the bottom line of the owners of these companies."⁷⁴ Moreover, it is possible that, once the effects of the pandemic start impacting with higher intensity on the jobs and income of workers, an important fraction of Americans will come to share the sentiment the sentiment that President Trump's tax

⁷³ Zeballos-Roig, Joseph, "From the wealthy to Wall Street, here's how the 2020 Democrats would redraw the US tax code with their plans," Business Insider, February 1, 2020. <https://markets.businessinsider.com/news/stocks/democratic-presidential-candidates-tax-plans-effect-wealthy-wall-street-affect-2020-1-1028865128>

⁷⁴ Jagoda, Naomi, "2020 Democrats set sights on corporate tax hike," The Hill, October 27, 2019. <https://thehill.com/policy/finance/467549-2020-dems-set-sights-on-corporate-tax-hike>

cut is only benefiting corporations and high-income taxpayers, leaving political room for a proposal to raise the corporate tax rate that is likely to be a political winner for Democrats, even if it is not approved this year.

Recommendation

The direction of the deficits and debt in the country was troubling prior the Covid-19 pandemic, in a period in which the business cycle was, in fact, in an expansive phase. Now, with the addition of the effects of the pandemic and the implementation of the Coronavirus Aid, Relief, and Economic Security (CARES) Act, the federal deficit and are likely to exhibit an even more alarming trajectory. For instance, the CRFB states that “due to the effects of the crisis and legislation enacted to combat it, debt and deficits will now grow much higher, to never-before-seen levels.”⁷⁵ In line with this statement, the CRFB estimates that the federal deficit will reach the \$3.8 trillion mark, which is equivalent to 18.7% of GDP for this year, while debt held by the public will be greater than the size of the economy by the end of the FY 2020.⁷⁶

These new deficit and debt projections will likely have negative consequences regarding the necessary long-term adjustments required on the fiscal front to prevent a fiscal crisis in the future, adjustments that would have come from significant spending cuts, higher taxes, or a combination of these two budgetary concepts.

However, given the current situation regarding the Covid-19 pandemic, it would not be appropriate to increase taxes this year this year. As explained in the political analysis section, stimulus checks for American families, deferment of individual tax filings, and the provision of

⁷⁵ Committee for a Responsible Federal Budget, “New Projections: Debt Will Exceed the Size of the Economy This Year,” last modified April 13, 2020, accessed April 17, 2020, <http://www.crfb.org/blogs/new-projections-debt-will-exceed-size-economy-year>. 1.

⁷⁶ Committee for a Responsible Federal Budget, “New Projections: Debt Will Exceed the Size of the Economy This Year.” 1.

financial support, including demand-supporting policies for small businesses, will be the rule for the remainder of this year, and, perhaps, for the next two years, based on the lessons learned from the Great Recession.

Moreover, the CARES Act has also made important changes in favor of corporations, at least through to the end of this year. The legislation allows companies to write off a much larger portion of the interest paid on their debt — an especially valuable break currently, given that so many firms are borrowing as much money as possible to stockpile cash. The act also allows companies to completely offset any losses incurred against profits declared over the past five years.

Considering the facts described above and despite the potential of higher corporate tax rates to deal with deficits and debt presented in the memorandum, it is recommended that the proposal in this project to increase corporate tax rates from 21% to 25% should not be approved. As the CRFB president Maya McGuineas explained in late March, “if ever there were a time to borrow those resources (to combat the crisis and avoid an economic depression) from the future, it is now.”⁷⁷ In other words, the current environment demands the implementation of counter-cyclical policy tools to rapidly increase consumption instead of increasing taxes, which would have a contractionary impact on economic activity.

One of the most prominent monetary economists, Jordi Gali, noted that “a fiscal stimulus, in the form of a tax cut or increase in government purchases financed through money creation, provides a way to boost economic activity effectively, as long as prices are reasonably sticky.”⁷⁸ Recently, Gali analyzed the current situation with regard to Covid-19, concluding that there is an alternative to a strategy based on higher taxes and borrowing to finance the fiscal emergency. Such a strategy consists of “unrepayable funding by the central bank of the additional fiscal

⁷⁷ Ibid. 1.

⁷⁸ Gali Jordi, “The effects of a financed-money fiscal stimulus,” last modified July 2019, accessed April 16, 2020, <https://econ-papers.upf.edu/papers/1441.pdf>. 18.

transfers deemed necessary,” also known as “helicopter money.” Given that the emergency is currently here, this is the right time to implement this policy instead of increasing taxes.⁷⁹

It will also be difficult to gain approval for a proposal that increases the corporate tax rate due to the political-electoral environment. For instance, former Chief of Staff Mick Mulvaney recently said that there would be a new round of tax cuts if President Trump is reelected in November this year. Regarding corporate tax rates, he suggested that one possible change concerning the tax system would be a cut from the current 21% to 20%.⁸⁰ Although the current situation caused by the pandemic could dramatically change the presidential election scenario, placing the Democrats in a position to win, it is highly probable that lower taxes will be another promise from President Trump this year, thus lowering the likelihood that a proposal to increase corporate tax rates will be approved.

However, the relief packages to deal with the effects of the Covid-19 pandemic will cause the deficit and debt to skyrocket in the years to come. Moreover, since the projections from the CRFB and other experts could be underestimating deficits because they do not include further legislation that might be enacted in the near future, it will be necessary to explore and implement different ways to finance the worrying gap between federal outlays and receipts after the crisis and recovery to ensure that the debt and deficit return to sustainable numbers. In addition, given the possibility that the level of prices in the economy might react against the stimulus programs while there possibly might be shortages in some sectors amid a lower productive capacity as a result of the stay-at-home rules and business shutdowns, there will be less space for “helicopter money” policies. In addition, from the political economy point of view, once the economic activity

⁷⁹ Gali Jordi, “Helicopter Money: The Time is Now,” last modified March 17, 2020, accessed April 15, 2020 <https://voxeu.org/article/helicopter-money-time-now>

⁸⁰ Renu Zaretsky, “Taxes and the Coronavirus,” last modified March 2, 2020, accessed April 16, 2020 <https://www.taxpolicycenter.org/daily-deduction/taxes-and-coronavirus>

and employment start recovering lost ground, a new tax reform with higher corporate tax rates will

- Decrease the fiscal deficit and debt, as shown in the policy analysis section; and
- Lower the weight of non-conventional mechanisms, such as “helicopter money,” on total expenditures.

Considering the scenario described above, I ratify my recommendation to not approve an increase in the corporate tax rate this year. In the best-case scenario, such an initiative should wait until 2021 or until the economy recovers from the recessive stage of the business cycle, to be proposed and discussed in Congress. While tax justice campaigners should be calling for a strong fiscal stimulus which will lead to the poor and vulnerable paying less and the wealthy, including strong, profitable corporations, paying more, ideological elements should be put aside, and the implementation of effective policies that alleviate the struggling faced by American citizens amid the Covid-19 pandemic should have preference.

Curriculum Vitae

Milton Guzman is a native from Caracas, Venezuela, and is living in the United States since 2016. He holds a bachelor's degree in economics from the Central University of Venezuela, and a Master of Science in economics from Pompeu Fabra University in Barcelona, Spain. He has recently worked as an independent consultant for a U.S. contractor, supporting the work of the company to develop a municipal economic and debt surveillance model benchmarking Puerto Rico to other states. Before that position, Milton worked as senior economist for a U.S. investment advisor. He also held different positions in Venezuela as chief economist for Banco Santander and the Andean Development Corporation, a Latin American multilateral organization. In the academic front, he served as an undergraduate professor of economics at the Central of University of Venezuela and the Catholic University in Caracas, Venezuela.